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ELIMINATING THE FEDERAL
THRIFT CHARTER

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PREFACE

This paper explains the current differences between commercial banks and savings associations. It also examines the ramifications and costs of eliminating the federal thrift charter. It was requested by the Chairman of the House Committee on Banking and Financial Services to assist the Congress as it deliberates modernizing the laws concerning financial institutions.

This paper was prepared by Judith S. Ruud of CBO's Natural Resources and Commerce Division, under the supervision of Jan Paul Acton and Elliot Schwartz. The author wishes to thank Mark Booth, Patrice Gordon, Mary Maginniss, Marvin Phaup, Robin Seiler, David Torregrosa, and Timothy VandenBerg for their valuable comments on an earlier draft of this paper. The author also wishes to thank a number of individuals at regulatory agencies, law firms, and thrift institutions who provided useful information for aspects of this analysis.

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SUMMARY

As part of broader legislation that addresses modernizing and reforming financial institutions, the 105th Congress is considering legislation to eliminate the charter for federal savings institutions (or thrifts). That move would result in the convergence of the thrift and commercial banking industries.

For thrifts that must convert to another charter, the direct costs of that conversion include both one-time transitional costs—such as regulatory conversion fees, legal and accounting expenses, and the costs of changing all stationery and signage—as well as ongoing costs (or savings) from the new charter. The specifics vary with the complexity of the institution and the products it offers, the type of charter being converted to (and from), and the details of any legislation. For a simple mutual institution, the transitional costs of conversion could range from $45,000 to $135,000; for a median sized stock-owned institution, the costs could be $50,000 to $75,000 higher than the costs for a mutual institution. Those transitional costs for the average institution are much more significant than the ongoing costs. Together, those costs, when totaled for about 1,100 federally chartered thrifts, could exceed $100 million during the first year of transition and would decline substantially thereafter.

ARGUMENTS FOR AND AGAINST ELIMINATING THE CHARTER

Why eliminate the federal thrift charter? The motive stems primarily from the notion that the thrift charter has become obsolete in today's financial marketplace. The federal thrift charter originated to provide financing for housing. Many financial institutions now offer residential mortgages, and some people argue that savings institutions and commercial banks are indistinguishable for most consumers. Eliminating the thrift charter would also presumably eliminate the need for a separate oversight agency (the Office of Thrift Supervision, or OTS), thus streamlining regulatory structure. Another incentive for doing away with the federal thrift charter is to level the competitive playing field for thrifts and banks. Doing so would allow the two federal deposit insurance funds to merge, which would spread risk over a broader set of institutions.

Critics of that rationale argue that it is better to let the market rather than the government decide whether the thrift charter should be abandoned. Both the

commercial banking and thrift industries are already consolidating, but the thrift industry is not vanishing. Merging the deposit insurance funds and streamlining the regulatory agencies for depository institutions may produce economic benefits. But both could be achieved without necessarily doing away with the thrift charter.

A government mandate forcing thrifts to change their charter is sure to impose some costs. Policymakers may want to consider whether the costs imposed by eliminating the federal thrift charter are commensurate with the benefits gained by merging the deposit insurance funds, especially if those benefits can be attained without incurring the costs of eliminating the charter.

MERGING THE DEPOSIT INSURANCE FUNDS

The Deposit Insurance Funds Act of 1996 laid the groundwork for consolidating the commercial banking and thrift industries. The act legislated the recapitalization of the Savings Association Insurance Fund (SAIF) by a special assessment, and consequently allowed the Federal Deposit Insurance Corporation to close the gap in the difference between the premiums for deposit insurance that banks and savings institutions must pay at this time. The premiums are set independently, however, and may diverge in the future. The Deposit Insurance Funds Act of 1996 also stipulates that the SAIF and the Bank Insurance Fund (BIF) merge on January 1, 1999, provided that no insured depository remains a savings association on that date. If all federal thrifts did not voluntarily convert to national bank or state depository charters by the end of 1998, legislation to eliminate the federal thrift charter would be needed to allow the SAIF and BIF to merge under current law.

Merging the deposit insurance funds even without casting off the thrift charter makes economic sense. The SAIF insures fewer institutions with more geographically concentrated assets than the BIF does. Consequently, from the standpoint of insurance risk, a combined fund would have a lower probability of becoming insolvent than would the SAIF alone. The insolvency of a deposit insurance fund could impose costs on the general economy, the remaining depository institutions, and taxpayers.

Another reason to merge the funds is to do away with the instability that arises from having two insurance funds that provide the same product but may charge different prices. For example, problems in one part of the country—say, California—may hurt the SAIF more than the BIF and could force SAIF premiums to rise above BIF premiums, thereby placing SAIF-insured institutions in another

part of the country—say, New England—at a competitive disadvantage to their BIF-insured competitors.

The reluctance to merge the funds without eliminating the thrift charter stems, in part, from a desire to be fair to banks. Thrifts and banks have different attributes, with thrifts having certain advantages and banks having others. In particular, federal thrifts have better branching powers and greater latitude in holding company activities than banks do. However, whether thrifts possess a net competitive advantage over banks is by no means clear. If that was indeed the case, the predominant direction of voluntary changes in charters would be from banks to thrifts.

THE DIMINISHING DIFFERENCES BETWEEN BANKS AND THRIFTS

Historically, the federal thrift charter embodied five distinct advantages over the commercial bank charter. Those advantages were preferential taxation in accounting for bad-debt reserves, more liberal branching rights, broader power to preempt state law, broader subsidiary powers, and virtually unlimited activities for holding companies. The last two advantages give thrifts greater flexibility in carrying out business activities. However, although the thrift charter afforded some advantages, it yoked thrifts with a disadvantage against commercial banks by constraining lending activities. Thrifts are required to meet a "Qualified Thrift Lender" or QTL test, which requires that at least 65 percent of a thrift's portfolio be invested in qualified thrift investments, primarily residential mortgages and related investments.

Nevertheless, despite those clear distinctions, new laws and regulations are whittling away the differences between thrifts and commercial banks. The Small Business Job Protection Act of 1996 ended the preferential tax treatment that thrifts enjoyed over banks. The differences in the ability of thrifts to branch out should be largely eliminated after June 1, 1997, when the Riegle-Neal Interstate Banking and Branching Act takes effect. Not least, the Economic Growth and Regulatory Paperwork Reduction Act of 1996 significantly expanded the definition of qualified thrift investments, thus relaxing the QTL test.

THE IMPLICATIONS OF ELIMINATING THE FEDERAL THRIFT CHARTER

Requiring thrifts to convert to banks could harm thrift institutions in a variety of ways. Converting to a bank charter will involve costs—primarily legal expenses,

changes in signage and stationery, and conversion fees required by state and federal banking agencies. However, in addition to the direct legal costs of conversion, thrifts may have to alter their portfolio holdings and divest themselves of lines of business that are currently allowed for thrifts or thrift holding companies but not for banks.

At the same time, before the Small Business Job Protection Act of 1996 was enacted, a thrift converting to a bank had to recapture previous deductions for bad-debt reserves, a serious financial obstacle to charter conversion. Now that all thrifts have been forgiven their pre-1988 bad-debt reserves and may no longer simply deduct a percentage of taxable income as a reserve for bad debts, the tax burden is no longer an obstacle for a thrift in converting to a bank charter.

From the consumer's point of view, requiring that thrifts convert to commercial banks may reduce some benefits. The branching powers of thrifts and their expanded line of business powers may have made thrifts more convenient for their customers. Moreover, some types of nonconforming lending that thrifts do—but banks typically do not—may be curtailed.

Another path to expunging the thrift charter would be to restructure the federal chartering of all financial institutions. The appeal of that option is its potential for taking the best aspects of current bank and thrift charters and combining them. A new financial services charter will raise some issues that will be difficult to resolve, such as whether commercial firms should be allowed to own depository institutions. In addition, many institutions may find it costly to conform to a new financial services charter. Furthermore, a new financial services charter may expose the deposit insurance fund to excessive risk if insured institutions undertake unfamiliar activities without proper supervision.

Much change is occurring even without legislation. Regulators, such as the Office of the Comptroller of the Currency, are using their authority to expand the powers of banks. Depositories are "flipping" charters—that is, some banks are becoming savings institutions, and some savings institutions are becoming banks. Some institutions are also changing between state and federal charter. The federal thrift charter, however, is still workable, and market forces alone are not going to topple it.

CHAPTER I

A PROPOSAL TO ELIMINATE THE FEDERAL THRIFT CHARTER

House Banking Committee leaders opened the 105th Congress by introducing two separate proposals to eliminate the federal thrift charter. House Committee on Banking and Financial Services Chairman James A. Leach introduced the Financial Services Competitiveness Act of 1997, H.R. 10. Separately, Representative Marge Roukema, Chairwoman of the Subcommittee on Financial Institutions and Consumer Credit introduced the Depository Institution Affiliation and Thrift Charter Conversion Act, H.R. 268.

BACKGROUND

Many types of financial institutions providing various retail services exist in the marketplace today. Financial institutions that both take deposits and make loans are called depository institutions and are federally regulated. Commercial banks, savings institutions (or thrifts), and credit unions are insured depository institutions. Increasingly, financial institutions that essentially either take deposits or make loans —but not both—have cropped up. Such institutions compete with depository institutions for business. They are not, however, subject to the same regulations as depositories. Money market mutual funds, for example, effectively substitute for deposits, even though they are not federally insured and are not regulated as depository institutions. Similarly, mortgage banks make loans, but do not take deposits, and consequently, are not regulated as depository institutions.

What are the differences between commercial banks and thrifts? One difference is the structure of ownership. Commercial banks must be owned by stockholders, as opposed to being mutually owned, as thrifts may be. In a stock-owned corporation, the holders of the stock possess ownership interest in the corporation and may receive dividend payments. The stock is not necessarily publicly traded, but it may be closely held—by a family, for example. In contrast, mutually owned companies issue no capital stock; they are owned by their depositors (or policyholders in the case of mutually-owned insurance companies). In a mutual company, profits (after the deduction of business expenses) are set aside for the benefit of the depositors, or they are held as surplus reserves.

Commercial banks are for-profit, stockholder-owned institutions that provide loan and deposit services to the general public. Banks have a great deal of flexibility

in how they lend money. Commercial banks may be chartered at the national or state level. Savings institutions, or thrifts, may be mutually or stock owned and federally or state chartered. Thrifts include all federally charted savings and loans, federally chartered savings banks, and state-chartered savings associations. Savings institutions have traditionally specialized in consumer savings deposits and residential mortgage lending. The characteristics that distinguish those institutions from each other and from commercial banks are rooted in the technical legal distinctions embedded in the charters. From the consumer's point of view, all of the institutions have much in common: they all can take deposits and make loans, and the federal government insures their deposits up to $100,000 per depositor at each institution. In terms of deposits, savings institutions typically offer longer-term savings accounts and commercial banks typically offer shorter-term checking services. But in today's marketplace, either type of institution may offer deposit and loan services that are very similar to those offered by the other. That similarity was not always the case.

Savings and loan associations originated in the 1800s to provide mortgage loans to individuals. Such mortgages were not widely available from commercial banks at the time. Residential mortgages were undesirable to banks for several reasons. Lending on real estate collateral was considered bad banking practice. Moreover, because the loans tended to be held in the lender's portfolio until the debt was retired by the borrower, the lender had to tie up its funds for an extended period of time.

The typical type of mortgage loan has changed since the 1800s. In that century, mortgage loans were typically three- to five-year balloon loans, on which the balance was either paid off or refinanced when the loan matured. In the 1930s, balloon-mortgage homeowners got into trouble when they tried to refinance maturing mortgages at a time of declining home values. The long-term, amortizing mortgage was devised to avoid the balloon-payment problem. But no depository could reasonably hope to raise deposits with durations to match a 30-year mortgage. Hence, the Federal Home Loan Bank System was created as a source of liquidity and longer-term liabilities that would fund 30-year mortgages with much shorter-term deposits.

Thrifts faced the problem of "lending long and borrowing short." Such a pattern of lending for a long term, while borrowing for a short term, leads to a risk: the spread between the interest rate that institutions paid their depositors (whose accounts were the primary source of funds) and the rate that the institutions earned on the money it loaned out could turn negative. Thrifts also faced a portfolio problem in that the value of their assets (long-term loans) were more sensitive to changes in interest rates than were their liabilities.

REASONS TO ELIMINATE THE FEDERAL THRIFT CHARTER

Several arguments have been advanced in support of eliminating the federal thrift charter. One argument is obsolescence of purpose. Residential mortgages are now available from many types of financial institutions. Second, eliminating the federal thrift charter would help to streamline the federal financial regulatory structure by abolishing the Office of Thrift Supervision (OTS). Third, eliminating the federal thrift charter would level the competitive playing field for commercial banks and thrifts, and allow the two federal deposit insurance funds to merge—namely, the Savings Association Insurance fund (SAIF) and the Bank Insurance Fund (BIF).

The Obsolescent Purpose of Thrifts

The structure of mortgage financing has changed since the federal thrift charter originated. Mortgage lending once entailed relying on retail deposits as a source of funds for mortgage loans that were held until maturity. The primary source of earnings from that business, known as portfolio lending, was the spread between interest rates that the institution paid on deposits and earned on mortgage loans. That strategy exposed firms to the risk of illiquidity and the risk that the spread between interest rates earned on loans and paid on deposits could narrow. Those risks made the business of home mortgage lending relatively unattractive. The thrift charter was created to fill the niche of financing residential housing.

Several developments in the financial services markets have contributed to the increased availability of residential mortgages. The emergence of a large secondary market for mortgage debt has made the portfolios of home mortgage lenders much more liquid. Mortgage lenders are no longer required to hold whole loans to maturity. Instead, they can sell many mortgages that they originate to third parties and need not face the risk of holding mortgage loans for their full duration. Government-sponsored enterprises such as the Federal National Mortgage Association, wholly government-owned enterprises such as the Government National Mortgage Association, and private-sector financial institutions have all played a role in developing a secondary market for mortgage debt.

An active secondary market for mortgage debt made mortgage lending more attractive to potential suppliers of funds to the market for housing finance. That secondary market has also separated different steps in the lending process—specifically, originating, servicing, and financing. In the process, interest rate risk can be isolated and minimized as a drawback to lending, and greater

efficiency in each step can be realized. Separating the components of the lending process has eased entry to and increased competition in mortgage lending.

Although the secondary market works well for standard so-called conforming loans, secondary markets are not available for every type of mortgage. Adjustable-rate mortgages and high loan-to-value loans cannot be sold easily. Secondary markets serve a large percentage of mortgages, but what remains still represents a very substantial market. From the perspective of a borrower of a nonconforming loan, important differences exist between thrifts and other mortgage providers.

Now that a wide variety of financial institutions grant home loans, customers increasingly see little distinction between the services that banks and savings institutions offer. If the services that savings institutions and banks provide do not significantly differ, then merging the industries and streamlining the government regulatory agencies responsible for supervising them may be the most sensible approach.

Streamlining the Federal Financial Regulatory Structure

Eliminating the federal thrift charter would make it easier (although it would not be necessary) to abolish its federal regulator, the Office of Thrift Supervision. Four federal agencies now regulate depositories—the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Federal Reserve, and the Office of Thrift Supervision (OTS). (See Table 1 for a list of the number of depository institutions by regulator and by insurance fund.)

The FDIC, established during the Great Depression by the Banking Act of 1933, serves two roles—insuring all federally insured bank and thrift deposits and supervising insured institutions. In its supervisory capacity, the FDIC is the primary federal regulator for state-chartered commercial banks that are not members of the Federal Reserve System. It is also the primary regulator for most state-chartered savings banks and a secondary regulator for all other BIF- and SAIF-insured institutions.

The main commercial bank regulators are the Office of the Comptroller of the Currency and the Federal Reserve. The OCC, established in 1863 by the National Currency Act, charters and serves as the primary regulator of banks with a federal charter. The OCC is an agency of the Treasury Department. The Federal Reserve, established by the Federal Reserve Act of 1913, shares responsibility with the OCC for regulating national banks, which are required by law to be members of the

TABLE 1. NUMBER OF COMMERCIAL BANKS AND THRIFTS AT THE END OF 1996 (By federal regulator, insurance fund, and type of charter)

	Commercial Banks and Trust Companies			Savings Institutions		
		State Charter				
Primary Federal Regulatory (Insurance Fund)	National Charter	Federal Reserve Member	Federal Reserve Nonmember	Federal Charter	State Charter	Total FDIC Insured
Federal Deposit Insurance Corporation (BIF)	0	0	5,728	0	354	6,082
Federal Deposit Insurance Corporation (SAIF)	0	0	58	0	235	293
Office of the Comptroller of the Currency (BIF)	2,702	0	0	0	0	2,702
Office of the Comptroller of the Currency (SAIF)	24	0	0	0	0	24
Board of Governors of the Federal Reserve (BIF)	0	1,011	0	0	0	1,011
Board of Governors of the Federal Reserve (SAIF)	0	5	0	0	0	5
Office of Thrift Supervision (BIF)	0	0	0	27	0	27
Office of Thrift Supervision (SAIF)	0	0	0	1,057	251	1,308

SOURCE: Federal Deposit Insurance Corporation, *Statistics on Banking* (1996), Table 101, p. B-2.

NOTE: FDIC = Federal Deposit Insurance Corporation; BIF = Bank Insurance Fund; SAIF = Savings Association Insurance Fund.

Federal Reserve System. It is also the primary federal regulator for state-chartered banks that choose to become members of the Federal Reserve System, and the primary regulator for bank holding companies and their nonbank subsidiaries as well as for foreign banks operating in the United States.

The Office of Thrift Supervision—created by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 as successor to the Federal Home Loan Bank Board's regulatory oversight functions—is the primary regulator of all federally charted savings associations, state-chartered savings associations, and some state-chartered savings banks. The OTS is also the regulator of thrift holding companies. Like the Office of the Comptroller of the Currency, the OTS is an agency of the Treasury Department.

Although abolishing the OTS would streamline the federal regulatory structure of depositories, from a federal budgetary standpoint, it would not result in any savings and could actually result in an increase in federal regulatory cost. The OTS uses no tax money to fund its operations. Its expenses are funded by fees and assessments levied on the institutions it regulates. The OCC is also self-funded through fees and assessments. Premiums on deposit insurance fund the Federal Deposit Insurance Corporation, and the Federal Reserve is largely funded by the interest it earns on its holdings of Treasury securities. Neither the FDIC nor the Federal Reserve charge for the bank examinations they conduct. If thrifts convert to national banks, regulated by the OCC, no budgetary impact is likely to occur. However, if the FDIC and Federal Reserve picked up additional institutions to supervise, their workload would probably increase without a commensurate increase in income.

Merging the Federal Deposit Insurance Funds

Eliminating the thrift charter would allow for the Bank Insurance Fund and the Savings Association Insurance Fund to merge. Section 2704 of the Deposit Insurance Funds Act of 1996 provides for the funds to be merged on January 1, 1999, given that no insured depository institution is a savings association on that date. However, all federal savings institutions are unlikely to convert to national bank or state depository charters voluntarily without a law requiring it.

Before the Deposit Insurance Funds Act was enacted, the insurance premium assessed on SAIF deposits was substantially higher than the insurance premium assessed on BIF deposits. The reason for the differences in premiums was that the BIF's reserves had reached the statutorily mandated level of 1.25 percent of insured deposits. Therefore, the FDIC dropped the insurance premiums for BIF deposits,

whereas SAIF had not reached the statutory capitalization level yet and so SAIF premiums remained high.

The SAIF was slower to recapitalize, in part, because a large fraction of the deposit insurance premiums were not going into the SAIF but to pay interest on Financing Corporation (FICO) bonds. FICO bonds were issued to replenish the Federal Savings and Loan Insurance Corporation, the bankrupt predecessor of the SAIF. The FICO burden fell only on SAIF-member institutions. Thus, institutions were able to change their charter (so-called Sasser institutions) to avoid the FICO burden. Also, institutions that held SAIF-assessable deposits, but were not SAIF members, were not liable for FICO payments.

The Deposit Insurance Funds Act levied a one-time assessment on SAIF deposits that brought the SAIF up to its mandated capitalization of 1.25 percent of insured deposits. BIF and SAIF members now have the same structure for risk-based insurance premiums. Most banks are currently paying nothing in deposit insurance premiums.

Merging the SAIF and BIF makes good sense on grounds of diversifying. A combined fund could benefit from risk-pooling that could lower the probability of the insurance fund becoming insolvent, although that risk may be small. An OCC-FDIC study has analyzed historical bank and thrift failure and found that merging BIF and SAIF would reduce risk.[1] As FDIC Chairman Ricki Helfer testified before the Congress, "The SAIF has longer-term structural problems because it insures the deposits of far fewer—and more geographically concentrated--institutions. A merger of the SAIF with the Bank Insurance Fund (BIF) would address these problems and create a single, highly diversified, well-capitalized insurance fund. The FDIC strongly supports a merger of the two funds as soon as possible."[2]

An insolvency in a deposit insurance fund could impose costs on the general economy, the remaining depository institutions, and taxpayers. A fund on the brink of insolvency may be managed differently from a financially healthy fund. For example, a policy of regulatory forbearance—delaying closure of failing institutions—might be undertaken if the deposit insurance fund is strapped. The Congressional Budget Office has estimated that the delay in closing failed institutions during the thrift crisis of the 1980s roughly doubled the ultimate cost of

1. Jennifer L. Eccles and John J. Feid, *Two Deposit Insurance-Funds: In the Public Interest?* Economics Working Paper 97-5 (Washington, D.C.: Office of the Comptroller of the Currency, February 1997).

2. Statement of Ricki Helfer, Chairman, Federal Deposit Insurance Corporation, before the Subcommittee on Financial Institutions of the House Consumer Credit Committee on Banking and Financial Services, February 13, 1997.

resolving them.[3] If a deposit insurance fund approached insolvency, deposit insurance premiums would probably be raised to cover the cost. However, in such a situation, the remaining depository institutions may be hard pressed to pay the necessarily increased premiums. Alternatively, the number of institutions paying into the fund could fall to such a small number that they could not shoulder the cost. Thus, an increased probability of insolvency in a deposit insurance fund could expose taxpayers to costs.

Mergers and changes in charter have already blurred the distinctions between which institutions are being insured by each fund. Depository institutions are designated as BIF members or SAIF members, but many depository institutions hold both BIF-insured and SAIF-insured deposits. A member of one insurance fund can acquire deposits insured by the other fund. However, that portion of the buyer's deposits remains insured by—and assessable by—the other fund. Institutions with deposits assessable by the fund that they are not a member of are called Oakar institutions. At the end of 1996, BIF members held $217.3 billion in SAIF-assessable deposits, while SAIF members held $22.6 billion in BIF-assessable deposits (see Table 2 for the state-by-state breakdown of thrift institutions and assets both by federal or state charter and by insurance fund).

Changes in charters have further complicated the distinction of SAIF-insured and BIF-insured institutions. Savings associations that convert their charter to that of a commercial bank or BIF-member state savings bank become subject to supervision by the Federal Deposit Insurance Corporation, the Federal Reserve, or Office of the Comptroller of the Currency, but remain members of the Savings Association Insurance Fund. Such institutions are called Sasser institutions.

3. Congressional Budget Office, *The Cost of Forbearance During the Thrift Crisis*, CBO Staff Memorandum (June 1991).

TABLE 2. NUMBER AND ASSETS OF SAVINGS INSTITUTIONS AT THE END OF 1996, BY STATE, TYPE OF CHARTER, AND DEPOSIT INSURANCE FUND (In millions of dollars of assets)

	Total Savings Institutions		Charter		BIF Insured		SAIF Insured	
	Number	Assets	Federal	State	Number	Assets	Number	Assets
Alabama	14	1,971	14	0	0	0	14	1,971
Alaska	2	243	1	1	1	134	1	109
Arizona	2	515	2	0	0	0	2	515
Arkansas	16	3,403	14	2	0	0	16	3,403
California	66	248,032	53	13	2	66,511	64	181,521
Colorado	16	2,519	9	6	0	0	15	2,519
Connecticut	57	39,594	7	50	46	36,456	11	3,138
Delaware	5	2,162	4	1	2	1,708	3	455
District of Columbia	1	261	1	0	0	0	1	261
Florida	57	16,806	53	4	1	31	56	16,775
Georgia	35	5,834	35	0	0	0	35	5,834
Guam	2	261	0	2	0	0	2	261
Hawaii	5	6,567	3	2	0	0	5	6,567
Idaho	4	589	4	0	0	0	4	589
Illinois	141	49,828	76	65	2	398	139	49,430
Indiana	76	15,329	58	18	3	474	73	14,856
Iowa	30	5,906	30	0	0	0	30	5,906
Kansas	22	7,785	20	2	0	0	22	7,785
Kentucky	46	7,035	45	1	0	0	46	7,035
Louisiana	38	4,958	19	19	0	0	38	4,958
Maine	28	7,562	8	20	19	7,113	9	449
Maryland	71	9,807	68	3	1	41	70	9,766
Massachusetts	208	53,387	23	185	186	48,885	22	4,502
Michigan	26	26,474	24	2	0	0	26	26,474
Minnesota	23	6,093	22	1	1	48	22	6,044
Mississippi	14	2,642	11	3	0	0	14	2,642
Missouri	49	15,346	42	7	0	0	49	15,346

(Continued)

TABLE 2. CONTINUED

	Total Savings Institutions		Charter		BIF Insured		SAIF Insured	
	Number	Assets	Federal	State	Number	Assets	Number	Assets
Montana	10	1,827	10	0	0	0	10	1,827
Nebraska	13	8,735	12	1	0	0	13	8,735
Nevada	1	2,772	1	0	0	0	1	2,772
New Hampshire	25	9,272	6	19	20	8,664	5	607
New Jersey	92	48,622	37	55	12	13,990	80	34,632
New Mexico	10	1,433	8	2	0	0	10	1,433
New York	105	121,296	52	53	51	82,203	54	39,093
North Carolina	60	7,733	16	44	1	11	59	7,721
North Dakota	3	5,569	3	0	0	0	3	5,569
Ohio	159	51,881	69	90	3	2,210	156	49,671
Oklahoma	13	6,204	11	2	0	0	13	6,204
Oregon	9	14,283	8	1	2	11,876	7	2,407
Pennsylvania	122	45,207	48	74	10	3,360	112	41,847
Puerto Rico	2	310	2	0	0	0	2	310
Rhode Island	6	5,569	2	4	3	5,157	3	412
South Carolina	34	7,721	2	5	0	0	34	7,721
South Dakota	5	844	4	1	0	0	5	844
Tennessee	24	3,961	23	1	2	607	22	3,354
Texas	52	62,309	29	23	2	510	50	61,799
Utah	2	571	0	2	0	0	2	571
Vermont	7	2,358	2	5	4	1,331	3	1,027
Virgin Islands	1	57	1	0	0	0	1	57
Virginia	31	15,472	28	3	0	0	31	15,472
Washington	21	36,654	7	14	6	23,563	15	13,090
West Virginia	9	1,106	9	0	0	0	9	1,106
Wisconsin	51	25,175	17	34	1	486	50	24,689
Wyoming	4	340	4	0	0	0	4	340
Totals	1,924	1,028,192	1,084	840	381	315,767	1,543	712,424

SOURCE: Congressional Budget Office based on Federal Deposit Insurance Corporation, *Statistics on Banking* (1996), pp. F-2 to F-217.

NOTE: BIF = Bank Insurance Fund; SAIF = Savings Association Insurance Fund.

CHAPTER II

DIFFERENCES BETWEEN THRIFT AND COMMERCIAL BANK CHARTERS

Thrifts and banks derive their powers, or distinguishing characteristics, from both statutes and regulations promulgated by the regulatory agencies. As of December 31, 1996, there were 9,528 commercial banks and 1,924 savings institutions in the United States.[1] Under the nation's dual banking system, banks and thrifts may be chartered at the federal level or by state governments. A charter authorizes an institution to conduct business activity and specifies the corporate form of the institution. The presence of state and federal charters reflects the principles on which the nation's financial services industry was organized, and empowers the federal government to create institutions without encroaching on states' rights to do the same.

State-chartered depository institutions, however, have a federal regulator as well as state regulator. The Federal Reserve is the federal regulator for state-chartered banks that are members of the Federal Reserve System. The federal regulator for all other state-chartered banks and most state-chartered savings banks is the Federal Deposit Insurance Corporation. The Office of Thrift Supervision is the federal regulator of state-chartered savings and loans and some state chartered savings banks. As a deposit insurer, the FDIC is the backup federal regulatory for all institutions covered by the Bank Insurance Fund and the Savings Association Insurance Fund.

Thrift institutions are chartered in a variety of forms. In addition to differing by whether they are federally or state chartered, institutions vary by ownership structure and corporate form. Of OTS-regulated thrift institutions, 40 percent are mutually owned, meaning that they are owned by their depositors. The remainder are stock-owned institutions. Even though the number of mutual institutions is large, mutually organized thrifts control only about 10 percent of industry assets.[2]

About one-third of all thrifts are classified as savings and loans. The remaining two-thirds are organized as savings banks. No distinction exists between the savings bank charter and the savings and loan charter at the federal level; their differences are in nomenclature only. At the state level, charters for savings banks

1. Federal Deposits Insurance Corporation, *Statistics on Banking* (1996), Table 101, p. B-2.

2. Personal communication to the Congressional Budget Office by staff members of the Office of Thrift Supervision, June 6, 1997.

can be very different from savings and loan charters (see Table 3 for a summary of state thrift charters available).

The type of corporate form differs by region across the United States. New England states tend to be heavily populated by state-chartered mutuals, reflecting their long tradition in that part of the country. Mutual savings banks were more popular in the industrial cities of the North where large numbers of wage earners live than in the South where agriculture was the major economic activity. Federal savings and loans tend to be distributed in all parts of the country, reflecting the history of federal efforts to charter such institutions in locations in which state-chartered savings and loans were absent. The Congress established a federal charter for savings and loan associations in 1933. The federal charter was intended to bring housing finance to geographic areas that found themselves outside the nation's housing finance system at the time.[3]

CHARTER ATTRIBUTES DEFINE DEPOSITORIES

The key differences among depository charters are their portfolio requirements, lines of business allowed, structure of ownership and holding company, ability to branch, and tax treatment. Many of those differences have been converging as a result of recent laws modifying tax treatment, portfolio requirements, and branching (see Table 4 for a summary of some of the key remaining differences between the federal thrift charter and the national bank charter).

Regulations Governing Lending Limits and Asset Portfolios

One of the defining characteristics of a thrift is that it must satisfy a Qualified Thrift Lender (QTL) test, which requires that a specified percentage of the thrift's asset base be maintained in housing-related assets (such as home mortgages or mortgage-backed securities). Any thrift institution that fails that test is treated as a commercial bank for regulatory purposes. That test has been relaxed, as the definition of qualified thrift investments was recently expanded.

Regulations further restrict the composition of thrift portfolios by constraining them in some lending categories. For example, for federal savings associations, consumer lending is limited to 35 percent of assets and construction lending for

3. For more discussion of this issue, see Congressional Budget Office, *The Federal Home Loan Banks in the Housing Finance System* (July 1993).

TABLE 3. SUMMARY OF STATE CHARTERING

			Form of State Savings Bank Allowed	
	Savings and Loan Charter	Savings Bank	Mutual	Stock
Alabama	yes	no	n.a.	n.a.
Alaska	no	yes	yes	yes
Arizona	yes	no	n.a.	n.a.
Arkansas	yes	no	n.a.	n.a.
California	yes	no	n.a.	n.a.
Colorado	yes	no	n.a.	n.a.
Connecticut	yes	yes	no	yes
Delaware	no	yes	yes	yes
District of Columbia	yes	no	n.a.	n.a.
Florida	yes	no	n.a.	n.a.
Georgia	yes	yes	yes	yes
Hawaii	yes	yes	no	yes
Idaho	yes	no	n.a.	n.a.
Illinois	yes	yes	yes	yes
Indiana	yes	yes	yes	yes
Iowa	yes	no	n.a.	n.a.
Kansas	yes	no	n.a.	n.a.
Kentucky	yes	no	n.a.	n.a.
Louisana	yes	yes	yes	yes
Maine	yes	yes	yes	yes
Maryland	no	yes	yes	no
Massachusetts	yes	yes	yes	yes
Michigan	yes	no	n.a.	n.a.
Minnesota	yes	yes	yes	yes
Mississippi	yes	yes	n.a.	n.a.

(Continued)

TABLE 3. CONTINUED

	Savings and Loan Charter	Savings Bank	Form of State Savings Bank Allowed	
			Mutual	Stock
Missouri	yes	no	n.a.	n.a.
Montana	yes	yes	yes	yes
Nebraska	yes	no	n.a.	n.a.
Nevada	yes	no	n.a.	n.a.
New Hampshire	yes	yes	yes	yes
New Jersey	yes	yes	yes	yes
New Mexico	yes	no	n.a.	n.a.
New York	yes	yes	yes	yes
North Carolina	yes	yes	yes	yes
North Dakota	yes	no	n.a.	n.a.
Ohio	yes	yes	yes	yes
Oklahoma	yes	no	n.a.	n.a.
Oregon	yes	yes	yes	yes
Pennsylvania	yes	yes	yes	yes
Rhode Island	yes	yes	yes	yes
South Carolina	yes	no	n.a.	n.a.
South Dakota	yes	no	n.a.	n.a.
Tennessee	yes	yes	yes	yes
Texas	yes	yes	yes	yes
Utah	yes	no	n.a.	n.a.
Vermont	yes	yes	yes	yes
Virginia	yes	yes	yes	yes
Washington	yes	yes	yes	no
West Virginia	no	no	n.a.	n.a.
Wisconsin	yes	yes	yes	yes
Wyoming	yes	no	n.a.	n.a.

SOURCE: Congressional Budget Office based on data from the Conference of State Bank Supervisors and various state banking authorities.

NOTE: yes = charter present, no = charter absent, and n.a. = not applicable.

residential real estate is restricted to a maximum of 5 percent of assets. In contrast, commercial banks do not face such constraints. Banks have the flexibility to adapt their business mix to changing economic conditions. They are free to hold more diversified portfolios or specialize as they choose.

The Economic Growth and Regulatory Paperwork Reduction Act of 1996 (enacted on September 30, 1996) expanded the investment powers of savings associations and amended the definition of qualified thrift investments. The act provides that federal savings associations may include investments in educational, small business, and credit card loans as qualified thrift investments to meet the qualified thrift lender test. Federal savings associations may now invest in educational loans without limit. The previous limit was 5 percent of assets. The act also states that federal savings associations may also invest in credit card loans without limit. Furthermore, federal savings associations may now invest in commercial loans up to 20 percent of assets, provided that any amount over 10 percent is invested in small business loans. The previous limit for commercial loans was 10 percent of assets.

Lines of Business Allowed

Although federal savings associations are perhaps more limited than banks in their lending and portfolio requirements, they are allowed to engage in more lines of business than commercial banks. Major activities permissible for the service corporations of federal savings associations—but not for commercial banks—include real estate sales, development, management and insurance activities.[4] Of course, a difference exists between what activities thrifts may do in theory and how extensively they do them in practice.

A service corporation is a subsidiary of one or more thrifts (or banks) that performs services other than taking deposits for its owners and outside customers. Regulation may forbid the parent institution from directly performing those services. As of the end of 1996, 792 OTS-regulated thrifts reported investments in 2,323 service corporations. The greatest number of service corporations was in the business of real estate sales and development (504 service corporations) and insurance brokerages and agencies (397 service corporations).[5]

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4. However, insurance activities are increasingly becoming allowed for banks. A recent Supreme Court decision *Barnett Bank of Marion County, N.A. v. Nelson*, 116 S. Ct. 1103 (1996) held that states cannot restrict the federal authority granted to national banks under 12 U.S.C. Sec. 92 to sell insurance in towns with populations of less than 5,000.

5. Personal communication to the Congressional Budget Office by staff members of the Office of Thrift Supervision, Marchf 26, 1997.

TABLE 4. SUMMARY OF KEY DIFFERENCES BETWEEN THE FEDERAL THRIFT AND NATIONAL BANK CHARTERS

Characteristics	Federal Thrift	National Bank
	Lending	
Construction Loans for Residential Real Estate	Subject to a limit of the greater of 5 percent of assets or 100 percent of capital.	Permitted without limit.
Consumer Loans	Subject to a limit of 35 percent of assets.	Permitted without limit.
Commercial Loans	Subject to a limit of 20 percent of assets, provided that any amount over 10 percent of assets is small business loans.	Permitted without limit.
	Lines of Business	
Activities	Permitted service corporation activities include real estate development, real estate management, and selling insurance on an agency basis.	Service corporations may not engage in real estate development or real estate management. Insurance agency allowed only in towns of less than 5,000.
	Ownership	
Type of Firm	A federal thrift that meets the QTL test may be acquired by any company that does not threaten safety and soundness, provided that federal thrift is the only federal thrift subsidiary of that company (that is, the thrift is a unitary thrift).	National banks may only be acquired by companies that limit their activities to those deemed "closely related to banking" by the Federal Reserve Board.
	Branching	
Intrastate	With OTS approval, branches may be established anywhere in the home state, without regard to intrastate branching restrictions applied to state thrifts, provided they have adequate capital and meet CRA requirements.	With OCC approval, branches may be established anywhere in the home state, to the same extent state banks are allowed.
Interstate	With OTS approval, branches may be established in any other state or territory, provided they have adequate capital, meet CRA requirements, and meet the QTL test or qualify as a domestic building and loan association.	May establish branches through merger, subject to concentration limits, unless a state adopts a law prohibiting interstate branching.

SOURCE: Congressional Budget Office.

NOTE: QTL = Qualified Thrift Lender; OTS = Office of Thrift Supervision; OCC = Office of the Comptroller of the Currency; CRA = Community Reinvestment Act.

In November 1996, the Office of the Comptroller of the Currency amended its regulations to broaden the lines of business subsidiaries in which national banks may engage. The amended regulation allows operating subsidiaries to engage in activities that are part of or incidental to the business of banking, as determined by the OCC, even if the national bank is not permitted to engage in such activities directly. Although the OCC has not specified what new activities would be allowed, the amendment is significant since operating subsidiaries of national banks were previously only permitted to engage in activities that were permissible for their parent national bank.

Peculiarities of Holding Companies

A savings and loan holding company—unlike a bank holding company—generally may qualify to engage in an unlimited range of activities either directly or through affiliates. Bank holding companies may engage only in activities that the Board of Governors of the Federal Reserve System deem "closely related to banking." In general, the Glass-Steagall Act prevents banks from underwriting securities. Banks may engage, however, in underwriting some securities to a limited extent through so-called "Section 20" subsidiaries. Federal savings associations are not subject to the Glass-Steagall Act and thus may sponsor, advise, and distribute mutual funds through service corporations. Banks and bank holding companies may serve as investment advisers and act as agents to sell mutual fund products. Nevertheless, they are generally precluded by the Glass-Steagall Act from sponsoring mutual funds or distributing shares of mutual funds to the public.

Another significant difference between banks and thrifts is that national banks may only be owned by companies that limit their activities to those deemed closely related to banking by the Federal Reserve Board. A company engaged in any business that does not threaten safety and soundness may acquire a federal savings association that meets the QTL test, provided that the company has only one savings association as a subsidiary (a unitary thrift holding company). In other words, virtually any commercial firm may own a thrift.

The Ability to Branch

Federal savings associations are permitted to establish intrastate and interstate branches without restriction. In contrast, banks have historically been quite limited in their ability to branch. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Riegle-Neal Act), which became effective June 1, 1997, liberalized the rules for banks branching out. The Riegle-Neal Act authorized banks

to branch out interstate through merger transactions. The one exception was if a state specifically "opted out" of the federal interstate branching scheme established by the statute.[6] The act also allows banks to establish new interstate branches if a state "opted in" to *de novo* interstate branching.

TAX TREATMENT OF BAD-DEBT RESERVES

When computing taxable income, businesses are generally permitted to deduct the value of losses that they incur when customers do not repay their loans. Section 593 of the Internal Revenue Code allowed thrift institutions that satisfy a test to measure deductions for bad debt using a reserve method that is more generous than the methods available to other for-profit organizations such as commercial banks. Specifically, thrifts could shelter some of their current income from taxation by designating a percentage of their taxable income as a reserve for future losses without regard to actual or even anticipated losses.

Normally, if a thrift converted to a commercial bank or failed to maintain the required fraction of qualifying assets, it could no longer set aside bad-debt reserves and would become liable for taxes on the sheltered income from the reserves of previous years. The tax penalty for converting from a thrift to a bank charter could be a substantial obstacle to such a switch in charter.

Section 1616 of the Small Business Job Protection Act of 1996 equalized the taxation of banks and thrifts in accounting for bad debts by repealing the section 593 percentage-of-taxable-income reserve method of accounting for bad debts by thrift institutions. For tax years beginning after December 31, 1995, thrifts may no longer use the method of accounting for bad debts by putting aside a percentage-of-taxable-income in a reserve fund. The act also eliminated the requirement that a savings institution converting into a commercial bank must recapture into taxable income its deductions for pre-1988 reserve fund for bad debts. Taxes on bad-debt reserves established after January 1, 1988, must be paid over a six-year period starting in 1996.[7] By eliminating a tax advantage that thrifts have previously enjoyed, section 1616 of the Small Business Job Protection Act of 1996 effectively removed one obstacle to savings associations converting to commercial banks, as well as one of the major costs that they would incur were they required to convert by legislation.

6. So far only one state, Texas, has opted out.

7. Thrifts that retain a substantial amount of mortgage lending (satisfy a "residential loan test") may delay recapturing bad-debt reserve deductions for two years.

CHAPTER III

ISSUES IN ELIMINATING THE FEDERAL THRIFT CHARTER

Both H.R. 10 and H.R. 268 mandate that federal thrifts choose a new charter—either a national bank charter or a state depository charter. Moreover, no new thrift charters would be issued at the federal level. If a federal thrift took no action by January 1998, the institution would automatically be designated as a national bank. State thrifts would be treated as state banks for the purposes of federal banking law.

That proposal may be easier to carry out administratively than the alternative—coming up with a new common charter for all insured commercial banks and savings associations (see Box 1 for a brief discussion of a new single charter). However, the option would still be difficult to carry out in practice. Forcing thrifts to convert may be costly. Since thrifts currently may be involved in lines of business that are not allowed for banks, a number of thrifts would be forced to divest some of their lines of business. Furthermore, requiring federal thrifts to become banks and reclassifying state thrifts as state banks would have regulatory consequences.

BOX 1.
ELIMINATE THE THRIFT CHARTER BY CREATING A NEW CHARTER

One proposal advocates creating a new unitary federal depository charter rather than simply eliminating the federal thrift charter. The advantage of creating a new federal depository charter is that it could embody various aspects of both the national bank charter and the federal thrift charter. The difficulty of creating a new unitary federal depository charter would be deciding what powers and characteristics should be included in a new charter. A chief item of debate is whether commercial firms should be able to own depository institutions. Under current law, a commercial firm may own a thrift (in a unitary thrift holding company), but not a bank.

Creating a new charter for federal depository institutions will probably require reorganizing regulatory agencies and reassigning institutions to federal regulators. The question of whether oversight should be "umbrella" supervision (as the Federal Reserve currently has over bank holding companies) or "functional" regulation at the institutional level would also need to be resolved.

In addition, the Congress must decide what powers should be allowed for federal depository institutions. If the thrift charter is being eliminated in part because some of the lines of business that thrifts may engage in are raising concern, then those lines of business may be excluded in a new charter.

REQUIREMENTS FOR DIVESTITURE

To bring the powers of thrifts in line with the powers of banks, both H.R. 10 and H.R. 268 would require thrift institutions to cease their nonconforming activities in real estate and insurance. The bills provide the institutions two to four years to divest.

Under current law, federal thrifts may operate service corporations that engage in real estate development and insurance sales. The service corporations of federal thrifts may act as agents—without geographic limitation—for accident, auto, health, liability, life, and title insurance. The thrift itself may act as an agent for credit-related insurance and fixed-rate annuities. As of the end of 1996, 792 OTS-regulated thrifts operated 2,323 service subsidiaries. Over half of those subsidiaries were engaged in activities currently denied to commercial banks: real estate development and sales (504), acquiring improved real estate for sale or rental (271), and insurance brokerage (397).[1]

The Impact of the Divestiture Requirement on Federal Thrifts

On the one hand, assuming sufficient time and well-developed markets for divestiture activities, thrifts should not experience any economic losses from them. Instead, one would expect them to be able to sell their interests at fair market-value prices, avoiding any losses other than the transaction costs from the sales. Furthermore, ambiguities at the state level, as well as current controversies surrounding national bank insurance powers, indicate that federal thrifts would be able to avoid divestiture, particularly by pursuing a state thrift charter.

On the other hand, forced divestiture could hurt some institutions. One side effect of forced divestiture is that some assets that the thrifts expected to hold to maturity and carried at book value would have to be reclassified as available for sale and carried at market value. If the market value of those assets dropped, the thrifts would be financially squeezed. For example, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) forced thrifts to dispose of their junk bond holdings over five years. After FIRREA was enacted, the junk bond market collapsed and thrifts with significant holdings of junk bonds were seriously hurt.

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1. Personal communication to the Congressional Budget Office by staff members of the Office of Thrift Supervision, March 26, 1997.

The reason that proposed legislation has provisions for extensions is to avoid fire sales that would cause thrifts to take huge losses in a suddenly saturated market. However, if thrifts are in thin markets or geographically isolated areas, they may find it difficult to locate buyers.[2] In addition, the value of the same insurance or real estate subsidiaries might be lower to potential buyers than to the seller when brought to market. For thrift institutions with substantial synergies between their standard banking operations and their insurance or real estate operations, that scenario will in fact take place. The costs of joint production may simply be much lower than the costs of separately producing any two products. In that situation, the thrift would not be expected to recoup the full value of the nonconforming activity because the fair market value of the independent activity would be lower than the value of the operation when it was conducted by the thrift.

Consider one example of that principle: an insurance firm will face substantially different costs trying to market its product if it has to advertise in the print media, sell door to door, or set up a storefront. In contrast, a thrift can market the same product from its existing branches by mailing information to depositors along with their monthly statements. The thrift's costs of marketing the product would therefore be lower.

Ambiguities in Divestiture at the State Level

The Thrift Charter Conversion bills do not explicitly compel states to restrict the nonconforming powers of the thrifts that they charter, and some states already permit state-chartered banks to engage in insurance activities. Consequently, a number of ambiguities arise about the future powers of state thrifts. In addition, although the Federal Deposit Insurance Corporation Improvement Act (FDICIA) stipulates that national bank powers are to serve as a standard that state banks are not to greatly exceed, the national standard has been changing in recent months as the Office of the Comptroller of the Currency has been broadening the insurance powers of national banks. Exactly how much divestiture a state-chartered thrift would be required to undergo is therefore unclear.[3]

2. Where a thin market is equivalent to a small town, however, the exemption for small-town commercial banks would apply and the financial institution would not have to stop sales of insurance.

3. In the case of the Magna Bank, for example, the Office of the Comptroller of the Currency allowed a state-chartered depository institution to continue its insurance operations after it converted to a national bank charter, deeming it an "investment" of the company rather than a "power" per se. In the case of Barnett bank, the OCC ruled that the bank could sell insurance beyond the borders of the town of fewer than 5,000 people that originally gave the institution its authority to enter the insurance business.

How the ambiguities surrounding state powers and permissible insurance activities for commercial banks are resolved will be critical in determining what incentives exist for federal thrifts to choose a state thrift charter rather than a commercial bank charter. In cases in which a state thrift charter would allow a federal thrift to continue nonconforming activities that are extremely profitable, the federal thrifts whose activities in insurance or real estate development are a major source of revenue would have an incentive to choose state thrift charters. By selecting a state charter, the thrift would be able to circumvent the constraint on its current operations that the proposed policy changes introduce. However, if a thrift institution currently generating substantial revenue from insurance activities would have comparable insurance powers as a national bank, no such incentive to favor one charter over another on the grounds of nonconforming insurance activities would exist.

BRANCHING AUTHORITY

The Thrift Charter Conversion bills allow thrifts to retain all existing branches, but branching authority would be restricted in the future.[4] That provision would remove one of the factors that currently adds value to the thrift charter, as compared with the branching authority of the commercial bank charter.

Even though the bills would curtail the branching authority of thrifts, its restrictions apply only to future branching capabilities. The provision should not therefore impose substantial costs on thrifts. It represents a departure from the current operating environment. It would not, however, require thrifts to dispose of branches acquired thus far under their special authority.

That change in authority would entail costs for an institution only if it can be argued that the thrift was building the value of its franchise based on a branching network and that the bill prevents the thrift from being able to get its network off the ground. In that case, the value of existing branches to the firm might be undermined. However, because the federal prohibition on interstate bank branching expires in 1997, that potential impact is minimized.[5]

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4. In both H.R. 10 and H.R. 268, the rule on branching explicitly includes agencies as well as branches, and the provisions extend to cover branches and agencies that were being established when the legislation was proposed. The cutoff date in H.R. 10 is January 1, 1997. The cutoff date specified in H.R. 268 is January 7, 1997.

5. Although the Riegle-Neal Act does not confer branching authority that is equal to the current powers of federal thrifts, it does reduce the current discrepancy between thrifts and commercial banks. It should therefore minimize the potential for lost franchise value.

LIMITS ON LENDING

Thrift institutions are given three years to conform to lending limits for commercial banks in both House bills for converting thrift charters. H.R. 10 singles out loans to one borrower in particular, allowing thrifts to continue to hold those loans that do not conform to what is permissible for national banks for up to three years.

The provision is likely to be most important to small thrifts with significant investments in loans for construction or real estate development. For such thrifts, a given construction loan (or similar loan) may represent a high ratio of the thrift's capital simply because the thrift itself is small. Thrifts could then be expected to experience some losses from prepayment if they hold loans whose outstanding length to maturity exceeds that time period. If an active secondary market for those types of loans exists, however, a small thrift may be able to comply by selling the loan. From the standpoint of the affected borrowers, however, the provision could be detrimental.

THRIFT HOLDING COMPANIES

Many thrifts exist in holding company structures. Companies that own a single thrift are called unitary thrift holding companies.[6] Companies owning more than one thrift are referred to as multiple thrift holding companies. As of March 7, 1997, 832 thrift holding companies were operating—777 unitary ones and 55 multiple thrift holding companies. Mutual holding companies represent 33 of the 832 holding companies. In total, holding companies control about 80 percent of the assets of the thrift industry.[7]

Under the provisions of the Thrift Charter Conversion bills, the powers of unitary and multiple thrift holding companies are grandfathered. The ability to organize a holding company as a mutual holding company is also protected. Consequently, the 33 mutual thrift holding companies in existence can avoid the costs of converting to a stock ownership under H.R. 10 and H.R. 268. Existing laws and regulations allow thrift holding companies more liberal powers than bank holding companies. Protecting those powers is, therefore, a necessary part of

6. A unitary thrift holding company may own more than one thrift and remain a unitary thrift holding company if the additional thrifts were acquired in supervisory acquisitions.

7. Personal communication to the Congressional Budget Office by staff members of the Office of Thrift Supervision, March 20, 1997.

minimizing the costs that the legislative changes embodied in the bills would impose on thrift holding companies.

The charter conversion bills that have been introduced allow thrift holding companies to maintain their current powers provided that they satisfy certain prerequisites specified in the bills. The conditions include the types of investments of the subsidiaries of the depository institution, sales of those subsidiaries, and the acquisition of shares or assets of additional depository institutions by the holding company. For a holding company to have its current powers grandfathered, the bills require a holding company's insured depository institutions to continue to satisfy all of the lending requirements that are imposed at the present time, including the qualified thrift lender test. Holding companies meeting this requirement would be designated as "qualified bank holding companies." Grandfathering ceases if a change in control of the corporation occurs.

The Activities of Holding Companies

Although bank holding companies are generally limited to activities that are incidental to banking, a unitary thrift holding company faces no restrictions on the lines of business activity in which it may engage. A multiple thrift holding company may engage in any thrift-related activity in addition to activities that are permissible for bank holding companies. In short, a thrift institution in a unitary thrift holding company structure may actually be owned by any financial, or even a nonfinancial, company. The parent company may be involved in such activities as underwriting insurance, underwriting securities, or engaging in commercial and industrial enterprises.[8] Because they may only engage in thrift-related activities, multiple thrift holding companies do not have the unrestricted powers of unitary thrift holding companies. However, their ability to pursue different lines of business is still generally greater than the capabilities granted to bank holding companies.

Holding Company Affiliations

What kinds of enterprises can holding companies own? Bank holding companies are restricted from owning subsidiaries that are engaged in activities that are not incidental to banking. Unitary thrift holding companies have broader, more diverse affiliation powers. They may have ownership stakes in insurance companies, industrial corporations, securities firms, and real estate businesses. Those powers

8. This provision is contingent on the thrift subsidiary being able to satisfy the Qualified Thrift Lender test.

stand in sharp contrast to the powers of bank holding companies, making the structure of unitary thrift holding company unique.

By grandfathering current authority, the act would not impose new obligations on unitary and multiple thrift holding companies. Nonfinancial companies that own thrifts would not be required to sell their thrift subsidiaries, and holding companies with affiliates engaged in activities that are not incidental to banking would not have to sell their interests in those companies. Subsequently, no immediate costs would be imposed on those parent companies (other than the costs of registering with the Federal Reserve).

Because of the way that the bills protect the powers of thrift holding companies, the approximately 600 thrift institutions that are owned by holding companies have an incentive to maintain the structure of their traditional thrift portfolio rather than diversifying into other lines of lending. The incentives would be particularly strong for thrifts in the unitary holding company structure. After all, it is the unitary thrift holding company structure that, with its unrestricted powers, would stand to lose the most under the current rules governing bank holding companies. In addition, the unitary holding company typically contains only one thrift and hence should subsequently find it easiest to satisfy the criteria specified in the bills.

THE COSTS OF CONVERSION

The costs of converting to a new depository charter arise from many sources, such as legal fees, chartering fees, changing signs and stationery, and management time. Some costs of conversion result from complying with the regulations that apply to the different type of depository charter.

The institutional costs of conversion do not differ greatly between the options of converting to a national bank or a depository chartered by the state. A federal thrift's decision to choose a national bank charter or a state charter will be influenced more by the benefits conferred by the different charters than the transaction costs of converting to the new charter.

Institutional Costs

The standard conversion process requires an institution to make a one-time payment for its new charter. The cost is typically a fixed cost, though in a few states and with

the national bank charter, it can vary with the number of hours spent conducting a conversion examination. It does not vary specifically by the size of an institution's assets, although a few states have per-branch charges—which can be considered a measure of the scale of the retail banking activities of the firm. H.R. 268 specifically states that a federal savings association that converts to a national bank or state bank by June 30, 1998, shall not be required to pay any fees to any federal agency in connection with such conversion. H.R. 10, however, makes no such provision. Under the assumption that the charges would be similar to those now imposed for conversions, a federal thrift converting to a state chartered financial institution could expect to incur, on average, approximately $3,500.[9] Alternatively, the process of converting to a national bank would cost the typical financial institution either around $2,550 or $5,100 in fees, depending on the financial status of the institution.[10]

Not all federal thrifts would face the same options in selecting a new charter. Several of the states in which federally chartered thrifts currently operate do not charter savings and loans or savings banks. That could increase the actual cost of pursuing a state charter because it would require a federal thrift to change its corporate form in addition to paying stated conversion fees. More specifically, 22 states do not charter savings banks, and about 300 federal savings banks operate in those states. Those thrifts would have to become state-chartered savings and loans if they wanted to retain their thrift status. In one of those states—West Virginia—federal savings banks would not even have that option because West Virginia offers no state thrift charter. As a result, none of its thrifts would have any choice but to convert to state or federal commercial bank charters. The state's thrift activity would be limited to business conducted by existing branches of out-of-state federal thrifts that switched to state thrift charters in their home state.

Four states offer only one type of savings bank charter (either mutual or stock, not both). Consequently, some of their federally chartered thrifts would have to reorganize their ownership structure in order to retain their thrift status. That need imposes an additional burden on those institutions. Thrifts that would need to convert from a mutual to a stock form of ownership would have to incur the costs of obtaining an appraisal, a membership vote, and a stock offering in addition to applying for conversion. The additional financial burden might serve as a disincentive to seek a state thrift charter, since it raises the cost of the state charter compared with other options that allow for mutual organization.

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9. This figure is computed using information from the Conference of State Banks Supervisors. The calculation is based on the conversion fees of the 25 states reporting costs as fixed costs only.

10. These estimates assume that no assessment is paid as part of the conversion process. Whether an assessment is due depends on the time of year that the institution converts. Calculations are based on the OCC Bulletin (OCC 96-66) and OTS' Thrift Bulletin (Section 071, TB 48-9 and TB 48-13a).

About one-third of all federal thrifts are organized as a mutual institution. The provisions in the bills introducing changes to allow national banks to be mutually owned are therefore important. They make the national bank charter more widely accessible and more widely appealing by allowing institutions to avoid having to reorganize as stock-owned institutions if they select a national bank charter. As noted previously, those provisions would lower the cost of the charter to those federal thrifts, and they would affect the way the mutual organizations view the national bank charter compared with their state's thrift charter.

Four states do not offer a savings and loan charter. Like federal savings banks in states that do not have a savings bank charter, those institutions would face a smaller set of choices than their counterparts in states where the savings and loan option is available at the state level. If that more limited choice increases the likelihood that the federal thrift will choose a commercial bank charter, it reinforces the intent of the legislation for converting charters.

Legal fees are likely to be an order of magnitude higher than the conversion fees paid to state or federal regulators. Legal fees to convert to another charter are likely to vary considerably among institutions, and would be expected to be higher for an institution with multiple branches and varied lines of business than for a simple community savings and loan.

Legal fees for a typical, median-sized thrift to convert to a bank charter are likely to be in the range of $25,000 to $75,000. Those legal fees would cover the cost of filing the charter conversion documents and prefiling conferences with the old and new regulators. If a thrift had business that did not conform to what is allowed for a bank, the legal fees would likely be significantly higher.

For a stock institution, a charter conversion would require stockholder approval, and the cost of preparing proxy materials could range from $50,000 to $75,000. However, if thrifts have sufficient time allowed to convert, the shareholder approval could be obtained at the time of the thrift's annual meeting. Consequently, they would not need to incur the additional cost of special preparation and mailing of proxy materials.

Other institutional costs of converting include the costs of advertising, new signs, and stationery. The number of new signs necessary would depend on how many branches an institution had. When an institution changes charter, everything from loan forms to teller stamps must be replaced. Even a median-sized institution could incur $20,000 to $60,000 for new signs and stationery.

The costs of conversion could range from $45,000 to $135,000 for an ordinary thrift, plus an additional $50,000 to $75,000 if stockholder approval was needed. The cost could well be much higher for a thrift with assets and activities that do not conform to a bank charter's requirements. Still, choosing which charter to convert to is likely to be a decision based more on the attributes of the charter than on the initial conversion costs. The ongoing regulatory costs of the new regulator may also factor importantly in the decision of what charter to choose.

Regulatory Consequences and Costs

One of the provisions of the Thrift Charter Conversion bills is to abolish the Office of Thrift Supervision. Federal thrifts changing charter will be subject to a different regulator and will have different ongoing regulatory costs.

Abolishing the Office of Thrift Supervision. H.R. 268 would abolish the Office of Thrift Supervision.[11] Under its provisions, all federal thrifts would become subject to a new regulator. An institution that chooses a national bank charter would become regulated by the Office of the Comptroller of the Currency, which currently regulates all national banks. An institution that opts for a state charter would be regulated by state authorities and either the FDIC or the Federal Reserve. Who the regulator is determines what costs the depository institution will face for examinations and other services provided by the regulator.

The fees assessed by the different regulators are important for two reasons. First, they determine whether the bill imposes additional regulatory costs on the thrift institutions whose conversions are required by law. Second, the charges will factor into each thrift's decisionmaking process as it determines which new charter is optimal. Because the existing bank regulators do not charge the same fees, thrifts will have the ability to "shop around." Furthermore, because high regulatory costs detract from profitability, thrifts can be expected to favor the least costly regulatory regime when considering their different charter options.

Regulation by either the FDIC or the Federal Reserve appears to be less costly on average than regulation by the OTS. Neither the Federal Reserve nor the FDIC charges for its annual examinations, while the OTS and the OCC do charge for examinations. However, an institution whose federal regulator is the Federal Reserve or the FDIC is a state-chartered institution and would pay assessments and

11. Eliminating the Office of Thrift Supervision would streamline depository regulators, but would not likely result in any government budgetary savings. The OTS is funded by assessments paid by the thrifts it supervises, not by government appropriation. Savings in administrative costs would be offset by a loss of an equal amount of fees.

examination fees to its state authority. State assessments vary by state, but they are generally less than the OCC assessments on national banks.

Federal thrifts that switch to a national bank charter instead would also see some small changes in their regulatory costs as a result of existing differences between what the OTS and the OCC charge for assessments and annual examinations. The OTS currently charges $89 per hour for examinations; the OCC charges $49 per hour. For a $100 million-sized institution, semiannual OTS assessment charges range from $15,996 for a thrift in good financial condition to $23,989 for a financially distressed thrift. The typical OCC assessment on a $100 million-sized institution is $19,343.

How do the regulatory costs of the options remaining to federal thrifts fare in comparison to each other? State fees and assessments tend to be less than those that the OCC charges national banks. If the choice of charter was based solely on ongoing regulatory costs, thrift institutions would be apt to find state charters more desirable than the national bank charter.

<u>The Simultaneous Membership Requirement for the Federal Home Loan Bank System and the Federal Reserve System</u>. Federal associations that convert to national bank charters would be required to maintain simultaneous membership in the Federal Home Loan Bank System (FHLBS) and the Federal Reserve System (FRS). That requirement emerges because both bills require all nonvoluntary FHLBS members to continue their membership, while federal banking legislation currently requires all national banks to have membership in the FRS. The requirement may influence the relative cost of converting to the national bank charter compared with a state charter, for which no membership requirement is in place. Thus, it could serve as a disincentive to selecting a national bank charter.

Both the Federal Home Loan Bank System and the Federal Reserve System require their members to purchase the stock of affiliated banks (Federal Home Loan Banks or Federal Reserve Banks). For thrifts converting to a national bank charter, the Federal Reserve Bank stock purchase would be a new requirement. Federal Reserve member banks must subscribe to stock in their regional Federal Reserve Bank in an amount equal to 3 percent of their capital and surplus. Member banks receive a 6 percent dividend annually on Federal Reserve Bank stock. Federal thrifts would be unlikely to opt for a state charter instead of a national bank charter solely to avoid the required investment in Federal Reserve Bank stock.[12] Federal thrifts that

12. The Federal Reserve Membership does not confer any significant additional benefits, since thrifts have been eligible to borrow at the Federal Reserve's discount window since the passage of the Monetary Control Act of 1980.

expect more profitable investment opportunities to become available to them as state commercial banks will choose a state bank charter on the basis of an additional factor--the ability to leave the FHLBS and reallocate the funds that are currently tied up in FHLB stock to other uses.

State-Chartered Thrifts Treated as State Banks by Federal Banking Law. All state thrifts would avoid the costs of converting that are imposed on their federal counterparts. By redefining the category of "state bank" in the FDIC Act (12 USC 1813) to include state thrifts, both H.R. 10 and H.R. 268 would make state thrifts subject to the rules for state banks specified in the federal banking legislation. However, it would do so without requiring the institutions to take any action in terms of obtaining a new document to authorize their existence.

However, some state thrifts would be required to choose a new federal regulator. Under current law, the FDIC serves as the primary federal regulator for most state chartered savings banks.[13] That regulator would still be available to those savings banks if the legislation on charter conversion goes into effect. However, if new legislation abolishes the Office of Thrift Supervision, all existing state-chartered savings and loans would have to select a new regulator. Under state savings and loans' newfound status as state banks, the regulatory options currently available to state commercial banks (regulation by the Federal Deposit Insurance Corporation or regulation by the Federal Reserve) would presumably become available to them as well.

Even though the institutions may have to choose a new federal regulator, the decision should not be costly. Neither the Federal Reserve nor the FDIC has the current OTS policy of charging examination fees and levying semiannual assessments to cover operating costs, although the Federal Reserve does require its members to purchase FRS stock. Because choosing to be regulated by the FDIC exposes the thrift to no additional costs, state thrifts would have an incentive to choose to be regulated by the FDIC, unless the thrift perceives the yield on Federal Reserve stock in combination with some intangible benefits of being a Federal Reserve System member to be more desirable. State savings and loans can be expected to weigh the differences between the cost of FRS participation and its benefit, when deciding whether to opt to be regulated by the Federal Reserve or the FDIC.

13. Although the Federal Reserve Act permits mutual savings banks to participate, no such members currently exist in the Federal Reserve System.

CONCLUSION

Arguments may be made for and against abolishing the federal thrift charter. On the one hand, proponents argue that the thrift charter has become obsolete, since many financial institutions now originate home mortgages. Furthermore, eliminating the federal thrift charter would level the competitive playing field between banks and thrifts. On the other hand, opponents maintain that it is better to let market forces rather than the government decide whether the thrift charter should be abandoned.

Under current law, the merger of the SAIF and the BIF is contingent on eliminating the federal thrift charter. Many analysts believe that now is an opportune time to merge the deposit insurance funds. They argue that both funds are fully capitalized, the banking and thrift industries are profitable, and merging the funds is likely to reduce the probability of future insolvency in the deposit insurance funds. Others suggest that merging the insurance funds is the wrong goal: more fundamental reform of the financial services industry would be a more productive pursuit at this time, and the merger of the deposit insurance funds could be deferred because no emergency exists.

Eliminating the thrift charter will remove from the U.S. economy institutions that were created to facilitate home mortgage lending. However, the supply of resources available for home mortgage lending has expanded significantly and no longer depends on having a specialized lending institution such as a thrift. Moreover, recent legislation (the Economic Growth and Regulatory Paperwork Reduction Act of 1996) significantly expanded the definition of qualified thrift investments, those investments that a thrift was primarily required to hold. Thus, thrifts now are much less limited in their lending powers.

H.R. 10 and H.R. 268 would eliminate the thrift charter by requiring thrifts to convert to either national banks or state banks. H.R. 268 mitigates the cost burden on thrifts from mandated charter conversion by specifying that no fees shall be paid to any federal agency for converting a charter. However, state agencies may require fees, and other legal fees are likely. The direct costs of conversion include both one-time transitional costs such as legal and accounting expenses, the costs of changing all stationery and signage, and any ongoing costs (or savings) for the new charter.

The transitional costs will vary with the complexity of the institution, the type of charter being converted to (and from), and the details of any legislation. When totaled for the nearly 1,100 federally chartered thrifts, the transitional costs could exceed $100 million. Other costs of charter conversion are much more difficult to

quantify, such as costs that thrifts incur in divesting nonconforming business subsidiaries.

After the conversion is completed, there may be additional ongoing costs as well as savings associated with the new charter and operation. Furthermore, depending on the effects of other provisions of any legislation, the net changes in direct expenditure may result in savings or increased costs to the new institutions. Other savings or costs of broader legislative proposals for financial modernization are not addressed in this paper.